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DIRECTORATE OF
INTELLIGENCE

# Intelligence Memorandum

*South Vietnam's Business Recession*



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CENTRAL INTELLIGENCE AGENCY
Directorate of Intelligence
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INTELLIGENCE MEMORANDUM

# SOUTH VIETNAM'S BUSINESS RECESSION


**Summary**

1. A deep business recession is under way in South Vietnam following two relatively good years that included major economic reforms, significant increases in output, and greater stability. Import orders are down to a fraction of normal, industrial production has fallen sharply, and investment activity has almost ceased. The downturn began before the North Vietnamese invasion, as a result of difficulties in adjusting to the far-reaching reforms implemented in 1970-71 and the continued reduction in US troops and expenditures. Import liberalization led to a sudden surge in imports at a time when interest rate reform had greatly raised the cost of credit and consumers were increasing their savings. Many import firms found themselves in financial straits, and the resulting contraction of credit also hurt domestic producers, who at the same time faced a weak market because inventories of imported goods were unusually large.

2. The economic disruptions caused by the North Vietnamese invasion changed a mild downturn into a deep recession. Physical damage has been small, the South Vietnamese government was able to cope with the large flow of refugees, and most of the areas in which the Communists gained control are economically unimportant; nevertheless, it is clear that production has fallen greatly. The major problem is one of confidence, as it was during the 1968 Tet offensive, added to the financial problems that antedated the current offensive. Uncertain about the future, the South Vietnamese are trying to increase their cash holdings and are postponing expenditures, except for necessities.

3. The South Vietnamese economy could recover very quickly from the current recession when confidence is regained – much quicker than


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after the 1968 offensives because of the present lack of serious physical damage. And, after the adjustment period is passed, the recent economic reforms and the government's new dedication to flexible policies will put the economy in a stronger position for future growth.

## Discussion

### Prelude to Reforms

4. The sharp rise in the US presence and escalation of the war in South Vietnam in 1965 caused radical changes in South Vietnam's economic structure. Despite US commodity aid, the expansion of government-financed expenditures led to sharp increases in the money supply. Consumer prices followed suit, periodically fueled also by waves of commodity speculation tied to changes in the political or military situation, as shown in the following tabulation:

| | Percentage Increases | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Average Annual 1961-64 | 1965 | 1966 | 1967 | 1968 | 1969 | 1970 | 1971 |
| Saigon consumer prices | 5 | 50 | 55 | 33 | 30 | 34 | 30 | 14 |
| Money supply | 13 | 74 | 38 | 25 | 51 | 13 | 16 | 28 |

5. Saigon could do little to offset inflationary pressures. Deflationary fiscal policies were virtually impossible because of the requirements for large military expenditures. Monetary policies were largely ineffective because of the extreme weakness of South Vietnam's banking system. Although the economy was becoming rapidly monetized, relatively few people trusted or understood financial institutions. Nearly all commercial banks were concentrated in Saigon, with few customers other than importers.(1) Commercial bank demand deposits represented a small (and declining)

1. The primary anti-inflationary policy tool employed during the latter half of the 1960s was to allow a sharp expansion of imports in an effort to absorb excess liquidity created by US aid and expenditures. To facilitate these imports -- and to maximize government dollar earnings from US expenditures -- the piaster exchange rate was kept at an artificially low level.

proportion of the money supply, and there was virtually no long-term financial saving (that is, private term deposits in commercial banks) that could have reduced the inflationary impact of rapidly increasing liquidity.

6. One of the major reasons for the banking system's small economic role was a rigid and unrealistic interest rate structure. Until late in 1969, maximum interest rates paid on time deposits were less than 4%; loan rates averaged around 8% to 12%. During 1965-69, the average annual increase in consumer prices was about 40%. Thus, wealth held in the form of cash or financial assets was depreciating rapidly, and private holdings in the banking system were minimal. Because deposits were small, commercial banks had few loanable funds. Outstanding commercial bank credit to the private sector, adjusted for increases in consumer prices, actually declined by 30% between 1967 and 1970.

## The 1970-71 Monetary Reforms

7. A comprehensive interest rate reform for South Vietnam had been suggested at least as early as 1966. Given the tenuous political situation, the difficulty in raising (or even collecting) domestic taxes, and the requirement for government military expenditures, a sharp increase in interest rates appeared to be the most effective method of soaking up excess liquidity and revitalizing South Vietnam's financial system. After some initial dabbling, a sweeping reform occurred in September 1970 when the National Bank approximately doubled its discount rate and allowed commercial banks to set their own rates for loans and deposits. What emerged were loan rates ranging from 14% to 24%, compared with former rates of 8% to 14%. The rate for regular savings accounts rose from 5% to 10%, and new rates for time deposits ranged from 14% for three-month deposits to 20% for one-year deposits (previously 8% and 12%, respectively), or well above the rate of inflation (which declined sharply in mid-1970), as reflected in Table 1.

8. Private savers' responses to the interest rate increases were immediate. A 50% increase in commercial banks' time and savings deposits in the last quarter of 1970 and a further doubling of these deposits during 1971 were recorded. Partly in response to the increase in deposits, commercial bank credit to the private sector began its first significant expansion since 1966.

Table 1

Interest Rates and Financial Savings in South Vietnam

| | Interest Rate (Percent) | | Time and Savings Deposits (Billion Piasters at End of Period) |
|---|---|---|---|
| | On One-Year Time Deposits | Real[a] | |
| Jan 69 - Aug 69 | 3.5[b] | -23 | 12.3 |
| Sep 69 - Mar 70 | 8.0 | -20 | 15.3 |
| Apr 70 - Sep 70 | 12.0 | -13 | 17.9 |
| Oct 70 - Aug 71 | 20.0 | +7 | 43.4 |
| Sep 71 - Dec 71 | 21.0 | +5 | 54.0 |

a. Corrected for annual rate of increase in Saigon consumer price index during the period shown.

b. Rate for three-month deposits; one-year deposits were not introduced until August 1969.

9. Other late-1970 reforms included a devaluation of about 20%,(2) but even more significant than the specific measures taken at that time was the government's increasing flexibility in adapting policy to meet changing conditions in the economy. This was indicated by the series of reform packages implemented during 1971, including further interest rate changes, periodic exchange rate and tariff adjustments, import liberalization, and a rapid increase in the number of government-sponsored rural banks. South Vietnam's banking system began playing a more active role in financing government expenditures, and loans to domestic industry increased.(3)

10. The most important of the many 1971 reform packages was implemented in November, when another substantial devaluation and

2. Prior to recent reforms, South Vietnam's structure of exchange rates and import tariffs was extremely complex, with many exchange rates and a maze of customs, austerity, and perequation taxes with hundreds of different rates. Computation of effective exchange rates (effective import costs) thus are difficult. These estimates of effective devaluation, prepared by US officials in Saigon, combine the variations in both exchange rates and import taxes.

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3. [redacted] at least one-third of total bank credit to the private sector now finances domestic industry. However, most of these loans are still short-term in nature.

simplifications of the tariff system and importing procedures allowed market forces – rather than administrative rules – greater play in determining the type and volume of goods to be imported. One of the most important but least publicized of the many November decrees was the elimination of the licensing system for government-financed imports. Importers, rather than being forced to go through a complicated administrative procedure to obtain an import license, could henceforth simply buy their foreign exchange from commercial banks and order the goods they desired. This was a major liberalization of a system that was not only cumbersome but also rationed imports, frequently on the basis of graft.

## The Economy Prior to the Offensive

11. At the end of 1971, economic conditions in South Vietnam were much improved. Production was at a relatively high level, inflation had slowed, and the need for economic aid, although massive, appeared to have reached a maximum. But there were also major economic problems, some of which seemed likely to get worse. Although the rate of increase in Saigon consumer prices in 1971 was cut to less than half that of any year since 1964, there were clear signs that similar stability would be extremely difficult to achieve in 1972. Money supply, which had increased a total of only 31% in the two years 1969-70, grew by 28% in 1971 alone. Tax increases on many commodities, plus a sharp increase in rice prices in 1971, also put pressure on retail prices. The combination of these pressures brought about an acceleration of inflation in the second half of 1971 which continued through the first quarter of 1972, as shown in the following tabulation:

| | Percent | |
|---|---|---|
| Quarter | Saigon Consumer Price Increase Over Previous Quarter | Annual Rate |
| 1971 | | |
| First | 0.5 | 2.0 |
| Second | 0.7 | 2.8 |
| Third | 4.0 | 17.0 |
| Fourth | 5.2 | 22.5 |
| 1972 | | |
| First | 7.9 | 35.5 |

12. Although a respectable increase in output was achieved in 1971, a sharp increase in government domestic tax collection probably absorbed most of the increase in total personal income; private per capita consumption thus probably remained at about the 1970 level and may have fallen somewhat. Private investment also remained at a relatively low level. In addition, the government budget, which accounts for about one-third of gross national product, remained concentrated on current items, with virtually no fixed capital investment expenditures. Those sectors most dependent on US purchases (for example, beer and soft drinks, construction, and services) were suffering to some extent from the decline in demand resulting from US troop withdrawal. And, although the largest cuts were not expected until mid-1972, US layoffs of Vietnamese workers were causing some unemployment problems in areas where US base operations were being phased out.

13. Some undesirable effects of the November measures also were just becoming apparent prior to the launching of the North Vietnamese offensive. Although difficulties in collecting and reporting import statistics in the aftermath of the reforms obscured the pattern of activity, it is clear that import demand was extremely heavy during the last month of 1971 and the first quarter of 1972. Commercial bank credit to the private sector, most of it for financing imports – or for financing inventories of imported commodities – increased by nearly one-third in the first three months of 1972. Although annual interest rates for commercial loans were running near 30%, expectations of further devaluations and inflation, plus uncertainty on future foreign exchange availabilities, were factors leading importers to hold larger than normal inventories.

14. The prime factor in the increase in import demand, however, appears to have been the import liberalization accomplished by the November reforms. Importers who previously had to go through several government offices before receiving import licenses now went directly to commercial banks to obtain foreign exchange or letters of credit. In addition, although the measurable effective exchange rate was, on the average, raised, the import cost for many consumer goods, previously prohibited or carrying extremely high tariffs, was reduced. For example, prior to the reforms, most finished textiles were imported at an effective exchange rate of about 1,200 piasters to US $1; after the reforms the import rate was only 700 piasters to US $1 (including a special 200 piaster perequation tax). As a result, finished textiles, which had accounted for less than 10% of government-licensed imports in the first half of 1971, soared to over 30% of these imports following the November reforms.

15. An import boom clearly was under way in the early part of 1972, apparently caused in large part by importers' overreaction to the November

reforms. There also was a major shift in the composition of imports as consumer goods began accounting for a much larger share of total imports than in previous periods. Consumer goods, particularly luxury items, were pouring into the country. There was little, if any, increase in demand for capital goods or raw materials. There is no evidence of a decline in domestic consumer demand in the first quarter of the year. However, importers – as seen in retrospect – were clearly overestimating their ability to sell the goods in hand. Moreover, many importers, apparently failing to take the much higher interest rates sufficiently into consideration, carried excessive inventories for speculative purposes. As inventories continued to increase, the difficulties involved in financing them with short-term, high-cost commercial credit also mounted.

16. Soon a credit squeeze began. The sharp expansion of banks' outstanding loans, largely for import financing, resulted in many of them exceeding their legal loan/deposit ceilings. Moreover, in early March the government reinstituted advance deposit requirements on imports, which had been lifted in November 1971. Commercial banks became much more hesitant to grant new credit or to extend payment terms on old loans. Private demand deposits began to decline in February as businesses withdrew deposits in order to pay off loans and finance current expenditures. This forced a further curtailment of credit. With traditionally poorer access to the financial community than that enjoyed by importers, smaller domestic producers were hard hit.

17. The import boom collapsed in mid-March, two weeks before the Communist offensive began, and, with stocks of consumer goods abnormally large, a few industries (particularly textiles – Saigon's largest private employer and the one facing the most serious import competition) apparently had to cut production. In what appears to be a belated response to the sharp expansion of imports, the government raised loan and deposit interest rates by an additional two percentage points on 7 April. This move, announced a week after the start of the Communist offensive and several weeks after imports had already begun to decline, put even more pressure on domestic industries, already experiencing difficulties in obtaining loan financing.

## The North Vietnamese Offensive

18. The North Vietnamese offensive, now in its fourth month, has caused severe disruptions in the economy, although damage to productive facilities has thus far been small. About 850,000 civilians have fled from their homes; most of them are now being fed and sheltered in government facilities. Consumer demand dropped sharply, as it had during the 1968 Tet offensive, because of uncertainty about the future, and presently is

limited to necessities, thus further slowing business activity. Perhaps the most serious problem will be reawakening the confidence of potential investors, domestic and foreign, in the economy.

19. Business activity declined in the month following the offensive, but not as much as might have been expected. Many investment decisions, however, were understandably postponed. Consumers took on a "wait-and-see" attitude and chose to increase their cash holdings as insurance against sudden – but uncertain – personal requirements. This meant postponing purchases of most industrial consumer goods. Imports thus continued their decline. The fall of Quang Tri Province at the end of April caused a more serious drop in consumer confidence and demand. In Saigon, this resulted in a serious slowing of economic activity. Although limited commodity hoarding – particularly of rice and kerosene – was reported very early in the offensive, with overall Saigon retail prices rising 4% in the first two weeks of April, prices subsequently fell, and by the end of April they were at about the same level as in the preceding month. There was very little increase in Saigon retail prices in May and June. Black market rates for dollars now are actually lower than they were in March.[4]

20. The sharp drop in consumer purchases put most of Saigon's manufacturing industries into a deep recession. Sales of textile manufactures, with the exception of government orders for military use, virtually ceased, and production fell to about one-third the pre-offensive level. In the plastics industry, sales, production, and employment in the first four months of this year were reportedly about one-half the level of the same period in 1971. Both these industries were experiencing difficulties prior to the offensive, however, primarily as a result of import competition. Lumber milling dropped to an estimated 10% of pre-offensive levels, and pharmaceutical sales declined significantly. Private construction activity is continuing at near normal levels, but few new orders are being placed. Although different industries are affected in different ways, the same basic complaints come from the majority of them. These are: (1) the lack of demand; (2) the credit squeeze; and (3) the resulting need to cut output and working hours. Industry across the board is hurt, but it is the small firms which are feeling it most, and there are many reports of them having to shut down.

21. Another sector of the economy seriously affected by the recession is the import trade, including wholesalers and retailers of imported consumer

4. The stability of black market rates is mainly an indication of the high business demand for piasters, in turn the result of low consumer demand, excessive business inventories, and the credit squeeze. Private businesses in Saigon are exchanging part of their holdings of gold and dollars for piasters, thus offsetting the tendency of black market rates to rise as a result of the current uncertainty.

goods. The decline in import orders accelerated (see Table 2). In response, near the end of May, the government lowered advance deposit requirements from 100% to 75% for government-financed imports, and from 25% to 10% for commodities under the Commercial Import Program (CIP). During the period 1-9 June, a slight upturn occurred as openings of letters of credit for government imports totaled $4.1 million (CIP imports continued to decline). However, imports of finished textiles – rather than the hoped-for capital goods and raw materials – led the revival. In order to prevent textile imports from further injuring the depressed local industry, the government on 15 June added an additional 100-piaster perequation tax and an additional 200-piaster three-month advance deposit for textile imports.

Prospects for Recovery

22. On the surface, there appear to be some striking similarities between the urban economy in South Vietnam today and that following the 1968 Tet offensive. Major differences between the 1968 and 1972 offensives, however, limit the extent to which present projections can be based on post-Tet economic experiences. The 1968 offensives were concentrated in urban areas, with consequent heavy damage to industrial facilities, especially in the Saigon area. With the exception of the damage to South Vietnam's cement plant in Kien Giang Province in the Delta, the current offensive has thus far left the country's manufacturing industry virtually untouched. South Vietnam's political structure in 1968 also was much less stable than it is at present. Government response to the economic and refugee situation has been much more rapid and efficient in the present period. It took several months for industrial production to recover to the level reached just before the 1968 Tet offensive. In the present situation, recovery could be much more rapid.

23. For the immediate future, the most crucial factor for recovery is confidence. Neither consumer demand nor private investment spending will experience a significant upturn without a revival of Vietnamese faith in the future of the economy, although the drawing down of inventories will eventually end and production should then begin to revive somewhat. Confidence is, in turn, dependent on several factors, the most important clearly being the military situation. South Vietnam's judgment of the US economic commitment – of which economic aid is but one part – also will play a major role in future investment decisions.

24. Once relative peace is restored, the economic performance of the South Vietnamese government also will play a key role in determining the extent to which the economy can recover from the present recession and withstand US withdrawal. The 1970-71 reforms indicate the government's growing responsiveness to the economic needs of the country. Moreover,

Table 2

Import Orders for Government- and CIP-Financed Commodities[a]

Million US $

| 1972 | Government (New Letters of Credit) | CIP (Allocations of Exchange) |
|---|---|---|
| March | 38.7 | 22.0 |
| April | 16.5 | 11.2 |
| May | 4.6 | 6.7 |
| 1-14 | 2.9 | 3.9 |
| 15-31 | 1.7 | 2.8 |
| June 1-9 | 4.1 | 0.2 |

a. South Vietnam import statistics are inexact as well as often misleading. The above data should therefore be used only for rough comparisons. Many of the problems involved in gathering import statistics were exacerbated by the November 1971 reforms and the abolition of government licenses. This is particularly true of government-financed imports, which are recorded with a random lag averaging 5-7 weeks. The lag is caused by letters of credit issued by commercial banks on a particular date not being recorded by the government until weeks later; the date the letter of credit is recorded -- rather than issued -- is then used in compiling the data. The above series tabulates commercial bank letters of credit to importers on the date of issue. However, these data have been collected only since January 1972, and on a daily basis only since April. There apparently is no effective method of reconciling the above data with those of earlier periods. Also, the government and CIP data above are not strictly comparable, as it is believed that more cancellations of commercial bank letters of credit occur than do refunds of foreign exchange under CIP.

the private sector's reactions to the exchange and interest rate reforms show, in turn, that, even with years of instability and disruption, economic conditions can be significantly – and promptly – affected by government economic policies.

25. The government recently announced a series of economic measures to cope with the recession and economic problems of the war. These include tax increases to finance the war and refugee expenditures, special interest rates for particular industries, and measures to stimulate imports (especially raw materials). Other measures are contemplated. It is too early to judge the efficacy of these measures. However, [redacted] the recession may have already bottomed out, and selected increases in consumer spending and domestic production have recently been noted. Moreover, despite the war and the recession in Saigon's manufacturing industries, there is surprising stability in those areas of the economy not directly touched by the war. Although this stability is in part a result of the improved military situation, much credit also must be given to the series of economic reforms implemented in the past two years and to continuing government efforts to improve economic policy, planning, and performance. These efforts have increased the private sector's confidence in both the economy and the government and thus have limited the extent of the current economic downturn.

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